COMPETITION CONSTRAINTS IN SMALL JURISDICTIONS*

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Abstract. This paper discusses the constraints that small jurisdictions face in matters associated with competition law and policy in view of their small domestic market. Special reference will be made to Malta, where competition legislation is modelled on EC law. The thrust of the argument is that certain aspects of competition law may not be desirable to implement or may be more difficult to put in operation in a small state. It is concluded that exceptions, based on considerations such as improved efficiency, distribution, and overall consumer benefit, are likely to be of major relevance to small jurisdictions.

Introduction

This paper will focus on the constraints that small jurisdictions face in matters associated with competition law and policy in view of their small size. Special reference will be made to Malta, where competition legislation is modelled on EC law.

The paper will attempt to show that there are many factors associated with small domestic markets that have a bearing on competition law and policy. The thrust of the argument will be that certain aspects of competition law may not be desirable to implement or may be more difficult to put in operation in small states and other small jurisdictions. The paper is organised as follows. Section 2, which follows this introduc-

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tion, lists the characteristics of small jurisdictions which may have a bearing on competition law and policy. Section 3 discusses the factors that may render the application of competition law more difficult in small jurisdictions. Section 4 concludes the study by proposing some future directions regarding research on this issue.

Characteristics of Small Jurisdictions

The term "small jurisdiction" is often used when discussing small geographical entities. This term includes small independent states as well as parts of larger states with a degree of administrative autonomy, and island provinces or regions with an isolated geographical market. In this paper, small states and small jurisdictions are used interchangeably.[1]

The Meaning of Small Size

The size of a country can be measured in terms of its population, its land area or its gross domestic product.[2] Some studies prefer to use population as an index of size, while others take a composite index of the three variables. There is no general acceptance as to what constitutes a small jurisdiction, although a jurisdiction with a population of around 1 million or less would generally be considered as a small one.

So far there has not been any attempt to classify countries according to the size of their domestic market, although the issue has been discussed in a few studies (see for example Armstrong and Read, 1998; Murphy and Smith, 1999; and Gal, 2001; 2002). One possible indicator could be a composite index consisting of population multiplied by real consumption expenditure, suitably standardised for international comparisons. Such an index would take account of the number of actors and the value of transactions within a given market. A cut off point would also be needed

1. When in 1998 the University of Malta organised a conference on "Competition Law and Policy" the term "small jurisdictions" was used rather than "small states" to allow the participation of representatives from island provinces and dependencies with their own jurisdictions and geographical markets, and therefore have conditions and characteristics similar to those faced by small states.
2. On this question see Downes (1988) Jalan (1982) and Briguglio (1993).

to establish whether a domestic market, in a given jurisdiction, is to be considered as a small one.

Small Domestic Market

Small states are likely to have a small domestic market, which in turn limits competition possibilities, due to the ease of market dominance by firms.

In addition, a small domestic market tends to be characterised by natural monopolies in utilities, such as electricity, fixed line telephony, gas and water, where the relatively large overhead costs do not permit more than one entity to viably supply the service.

Another characteristic of small markets relate to barriers to entry. There are natural barriers, due to the poor chances of success of setting new business in goods and services already supplied by existing firms. In addition, in a small market bulk buying is often required to avoid excessive fragmentation of cargoes, especially in the case of raw materials, and this limits the number of players in that market. There may also be artificial barriers to entry, often imposed by governments, to make it viable for a business to invest in certain types of production of goods and services, where overhead costs are large, and hefty capital outlays are required. In many cases, entry is also limited in the provision of services where competition could be possible, but the nature of the service requires licensing.

Still another characteristic of small jurisdictions is parallel behaviour between firms, which tends to be easier to conduct where family ties predominate in business. In such circumstances, the competition authorities may find it difficult to distinguish between concerted practices and independent action.[3]

In addition, arrangements between importers and distributors involving restrictions with the aim of minimising intra-brand competition may be easier to put in place in small jurisdictions. Although this is likely to stem from self-interest, it may have beneficial impacts on the consumer since

3. See also Muscat (1998).

uncontrolled competition may usher in excessive fragmentation and instability. This issue will be discussed further below.

Market Failures and Externalities

In a small domestic market, especially in the case of islands, it is more likely to find market failures, due to a number of factors, including the existence of relatively large external social and environmental effects. In such cases, market forces cannot be relied upon to ration supply and demand. In Malta, for example, business activity tends to have relatively large environmental impacts. This often leads to the need to limit the number of producers, permitting existing producers to continue enjoying dominance, even if the market, small as it may be, can take more suppliers.

Limited Natural Resource Endowments

Small country size often implies poor natural resource endowment and low inter-industry linkages, which result in a relatively high import content in relation to GDP (see Briguglio 1993). In addition, there are severe limitations on import substitution possibilities (Worrell, 1992: 9-10).

This reality often leads to domination of the market by undertakings monopolising import channels. One also finds in small jurisdictions a strong resistance by the existing businesses against parallel imports and a strong lobby for exclusive dealing arrangements, on the grounds of rationalisation. The Director for Fair Competition in Malta has been reported as saying that resistance against parallel imports was one of the main problems relating to competition in Malta.[4]

High Reliance on Export Markets

A small domestic market gives rise to a relatively high dependence on exports (see Briguglio, 1993) and therefore on economic conditions in the rest of the world. The high degree of export orientation is essentially a pro-competition situation, since it implies an orientation to free trade

4. On this question see also Gatt (1996)

and competitiveness. However, as already explained, small size renders the exploitation of the advantages of economies of scale difficult, mostly due to indivisibilities and limited scope for specialisation, which give rise to high per unit costs of production. It is thus often the case that a critical size is required to enable a firm to compete in the international market, and again here, the argument for rationalisation, and against fragmentation, is a strong one.

State Aid

As is well known, in general state aid is considered as a distortion to competition[5] but in small states, especially insular ones, the case of support of this type may be stronger than in larger territories, given the high degree of economic openness of such states and the need to be internationally price competitive. There may therefore be a case for considering state aid as permitting some form of level playing field in cases where the small size and insularity have an important bearing on the cost of production.

Insularity and Transport Costs

Many small states and small jurisdictions are also islands, and therefore face additional transport costs, which are included in the price of imported industrial supplies and finished goods. Islands, being separated by sea, are constrained to use air and sea transport only for their imports and exports. Land transport is of course out of the question, and this reduces the options available for the movement of goods. Apart from high per unit cost of transport, insularity may also give rise to additional problems such as time delays and unreliability in transport services. These create risks and uncertainties in production. Such disadvantages are more intense for islands that are archipelagic and dispersed over a wide area.

5. The EU makes several exceptions to this principle and it has drawn up a number of guidelines on the extent to which these exceptions may be used, including aid granted for the purposes of restructuring and for rescuing companies which risk bankruptcy, aid for research and development, aid granted to promote Small and Medium-sized Enterprises (SMEs), aid to promote employment, aid for training, aid to assist deprived urban areas and aid granted to promote the environment. The EU also allows aid which is granted to promote economic development in disadvantaged regions to support investment projects and in certain cases to compensate for transport disadvantages.

An additional problem is that when transport is not frequent and/or regular, enterprises in islands find it difficult to meet sudden changes in demand, unless they keep large stocks. This implies additional cost of production, associated with tied up capital, rent of warehousing and wages of storekeepers.

Small Population Pool and Administrative Constraints

The size of the population has a bearing on competition law and policy. In small jurisdictions, where the population pool is small, the chances of finding the necessary expertise to administer competition law and policy are smaller.[6] Although smaller jurisdictions will need a smaller number of personnel, the proportionality rule does not hold, due to the problem of indivisibility, especially in matters associated with administration. As a matter of fact, the number of personnel and the cost of administration, per capita of population, are likely to be larger in small states when compared to larger states.

A related problem is that many government functions tend to be very expensive per capita when the population is small, due to the fact that certain expenses are not divisible in proportion to the number of users.

Implications for Competition Law

The characteristics of small states just described have implications associated with competition law and policy, notably abuse of a dominant position, agreements, mergers and enforcement of the law.

Abuse of a Dominant Position

Generally speaking, competition legislation does not take account of economic benefits[7] when considering abuse of a dominant position,

6. To make matters worse, many trained specialists originating from small jurisdictions often emigrate to larger countries, where their specialised services are better utilised and where remuneration is more attractive.
7. In other words, economic benefits are not traded off against the adverse effects of dominance as they are under Art 81 EC Treaty type of provisions—this lack of consideration to offsetting economic benefits could, in some cases, be detrimental to consumer welfare and consumer interests.

although dominance per se is not normally prohibited. In competition regimes modelled on Article 82 of the EC treaty, abuse arising from dominance, such as limiting production, applying dissimilar conditions, (including price discrimination to equivalent transactions), charging excessive prices and refusing to supply goods or services in order to eliminate a trading party from the relevant market, are generally prohibited, and once detected the undertakings responsible will be sanctioned.

There could be situations where what may be considered as abuse of dominant position in a large market, need not be so in a small market particularly with regard to discrimination, "excessive" pricing and foreclosure of the market. Conversely, in some instances what may constitute abuse in a small market need not be so in a large market, as maybe the case of refusal to supply.

Discriminatory conditions. In some cases letting dominant oligopolies indulge in discriminatory practices may be to the advantage of the consumer. As Gal (2001) argues, in oligopolistic markets discriminatory pricing may work against rigid oligopolistic price structures and could result in lowering prices to the benefit of the consumers.

Gal is also of the opinion that discounts are generally to be encouraged. She argues that:

> "To forbid them would often reduce efficiency and slow reactions to changed market conduct ....Discrimination in small economies, thus, merits a deeper analysis of its real effects on the market."[8]

Excessive pricing. Similarly, a seemingly excessive price, when compared to the price of similar products in larger countries, may be justified in a small jurisdiction, since this may be one way in which a firm could cover costs associated with importing the product, particularly in the case of islands where transport costs tend to be relatively high, or to cover the relatively high overhead expenses associated with importing small quantities or producing on a very small scale.

The issue of transport costs is very important in this regard. One

8. On this issue see also Buttigieg (1999).

implication on competition is that a straightforward comparison with analogous goods in nearby mainland markets may not be appropriate.

Foreclosure of the market. In small jurisdictions, where the number of players must necessarily be small, existing firms may tend to forestall new entrants, fearing that they will lose their share of the market. This is of course also true in the case or large jurisdictions, but the effect of new entrants on existing firms is likely to be more pronounced when the domestic market is small.

In the case of small domestic markets, the new entrants may find themselves suddenly controlling a large share of the market, as was the case with a supermarket chain in Malta. The sudden exit of this supermarket chain from the market left many business creditors at a disadvantage, and excessively destabilised the market, to the detriment of consumers. Such destabilising effects of exit and entry into the market are likely to be more pronounced in small domestic markets than in larger ones.

This does not mean that barriers to entry should be encouraged, but that:
(a) the limited number of players that can be accommodated in a small market constrains competition possibilities; and
(b) the high degree of instability that arises by the entry and exit of a relatively large firm should be given due importance when assessing consumer welfare in the context of competition law.

Refusal to supply. Due to the constraints of replicating infrastructural facilities, there is more scope for the application of the essential facilities doctrine in small jurisdictions. This of course leads to the argument that refusal to grant third party access to essential facilities owned and controlled by a dominant firm should be more readily checked in small markets (Buttigieg, 1999).

Thus for example, what to a US agency would not appear to be an essential facility as it could be replicated by a potential entrant who is just as efficient as the incumbent, in a small jurisdiction the first entrant would be able to monopolise the sector where there is heavy sunk costs. This would of course be an argument for considering as anti-competitive a refusal to grant access or to grant access on equal terms that in a larger jurisdiction would not be deemed an abuse of a dominant position.

These arguments relating to abuse of a dominant position should not be interpreted as proposing a case for allowing such abuse in small jurisdictions, but to explain that maximising consumer welfare may, in these jurisdictions, require an economic analysis which takes into account the issue of small size.

Agreements

In the case of certain agreements, restrictions are often legally permitted, if the agreement between undertakings contributes towards the objective of improving production or distribution of goods or services or promoting technical or economic progress.[9] This is the case in Maltese law. In other words agreements containing what may be called anti-competitive clauses may be exempt if, on balance, they have an overall positive impact on the economy.

In the case of Malta, various vertical agreements including certain exclusive distribution agreements, exclusive purchasing agreements, selective distribution agreements and franchise agreements and some horizontal agreements are allowed and exempted in block, on such grounds. Exemption regulations were adopted on Vertical Agreements and Concerted Practices (L.N. 271 of 2001), Research and Development Agreements (L.N. 177 of 2002), Specialisation Agreements (L.N. 178 of 2002) and Technology Transfer Agreements (L.N. 176 of 2002).

It may be argued that in small jurisdictions collaborative arrangements (horizontal as well as vertical ones) may have positive effects on the consumers, due to the advantages of business consolidation, given the very high incidence of micro enterprises in such jurisdictions. Acting on their own, micro enterprises are likely to face strong constraints in competing with larger foreign enterprises based in larger jurisdictions.

Consequently, it could be argued that a wider spectrum of agreements should be covered by block exemption in small states, to encourage consolidation of business.

9. This is subject to the so-called 'pass-on requirement,' meaning that consumers should ultimately get a fair share of the benefits, that the restrictions to competition are indispensable to achieve the benefits and that competition is not substantially curtailed as a result of the agreement.

Mergers and Efficiency

In the case of mergers, Malta's Regulations on Control of Concentrations state that:

> "concentrations that bring about or are likely to bring about gains in efficiency that will be greater than and will offset the effects of any prevention or lessening of competition resulting from or likely to result from the concentration, shall not be prohibited if the undertakings concerned prove that such efficiency gains cannot otherwise be attained, are verifiable and likely to be passed on to consumers in the form of lower prices, or greater innovation, choice or quality of products or services."[10]

In the *Guidelines on Efficiencies*, which accompany Malta's Regulations on Control of Concentrations, it is stated that the type of efficiencies that are more likely to be cognizable and substantial than others, are efficiencies resulting from shifting production among facilities formerly owned separately, which enable the undertakings concerned to reduce the marginal cost of production as these are more likely to be susceptible to verification, concentration-specific, and substantial, and are less likely to result from anti-competitive reductions in output. Such justifications to anti-competitive behaviour are found in competition regimes in certain countries, such as the US, Canada and Australia, where the efficiencies defence is expressly mentioned in the law. On the other hand, under EC Merger law it is only in the recently adopted new Merger Regulation that the efficiencies defence was finally recognised while it is still not expressly recognised under the law of several Member States.[11]

10. LN 294 of 2002 Reg 4(4).
11. Council regulation 139/2004 (2004) OJ, L24/22 Recital 29. It was sometimes argued that in assessing the legality of a concentration under the previous Merger Regulation, the European Commission did implicitly consider efficiencies as part of the dominance appraisal test. However, now, in the guidelines on the assessment of horizontal mergers published in February 2004 accompanying the new Council Regulation that replaced the previous Merger Regulation as from 1st May 2004, the Commission the Commission explicitly acknowledges that consideration of efficiency claims forms part of its assessment. It should be noted in this regard that in the US an anti-competitive merger would rarely be saved by the magnitude of efficiencies it generates because most are neither verifiable nor large enough to offset negative deadweight loss. Moreover the so called "pass on requirement", i.e. that efficiencies must be passed on to consumers means that perceived cost savings must be quite high and that makes it difficult for the defence to succeed (see Buttigieg, 2003).

However, in a small country, where market dominance and natural barriers to entry are common, and sometimes cannot be easily dismantled, efficiency clauses are likely to have more significance. In such cases, merger control that does not sufficiently acknowledge efficiencies may actually impede restructuring of firms, in their attempt to attain a "critical mass".

Another argument in this regard relates to network benefits. Such benefits acquire greater relevance in the so-called "new economy" sector. In such sectors, concentration could enhance consumer welfare, as otherwise consumers would lose the benefit that a more extensive network generates in such sectors, including wider choice of complementary products and enhanced quality and service that this brings about. For example, in mobile telecommunications, as more users join a particular mobile network, that network becomes more valuable to those users as they can contact more people, in more locations, at lower cost as the network expands. In the transport sector, more integrated transport services can lead to network benefits that would improve service quality through strengthened hubs, better through-ticketing arrangements, more extensive services, more comprehensive and coherent information or better co-ordination of connecting services.

The relevance of all this to small jurisdictions is that the positive impact on the economy arising from mergers are likely to be more pronounced than in larger states, due to the fact that in a small market it may be desirable to avoid excessive fragmentation and encourage consolidation.

Implications Relating to the Culture of Competition

In small jurisdictions, the culture of competition may not easily take root due to the fear that intense competition may destabilise a small fragile and thin market. Another reason is that, as already noted, government involvement in such states tends to loom large over the market, and public undertakings often clamour for exclusion from competition law provisions claiming that they have a social role to play. In addition, the advantages of business consolidation and the disadvantages associated with business fragmentation often lead authorities of small states to justify monopolistic and oligopolistic structures.

Furthermore even where, in small states, competition legislation is in place, its enforcement may be more difficult than in larger countries due to the fact that everybody knows each other, and social and inter-family links predominate. Thus, in small jurisdictions, methods other than enforcement may sometimes bring better results as far as implementing competition policy is concerned. Competition advocacy among citizens, to render them aware of the benefits of competition policy are of relevance in this regard.

Conclusion

This paper has highlighted a number of areas which are associated with small jurisdictions and which are likely to have a bearing on competition law and policy. The main argument put forward in the paper is not that competition rules should not be adopted in small jurisdictions or that abuse should be tolerated.

The basic contention is that exceptions, normally based on considerations such as improved efficiency, distribution, and overall consumer benefit, are more likely to be relevant in small jurisdictions. The arguments are various, and may have legal as well as policy implications.

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